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Random musings for traders at TD Ameritrade—SPRING 2021

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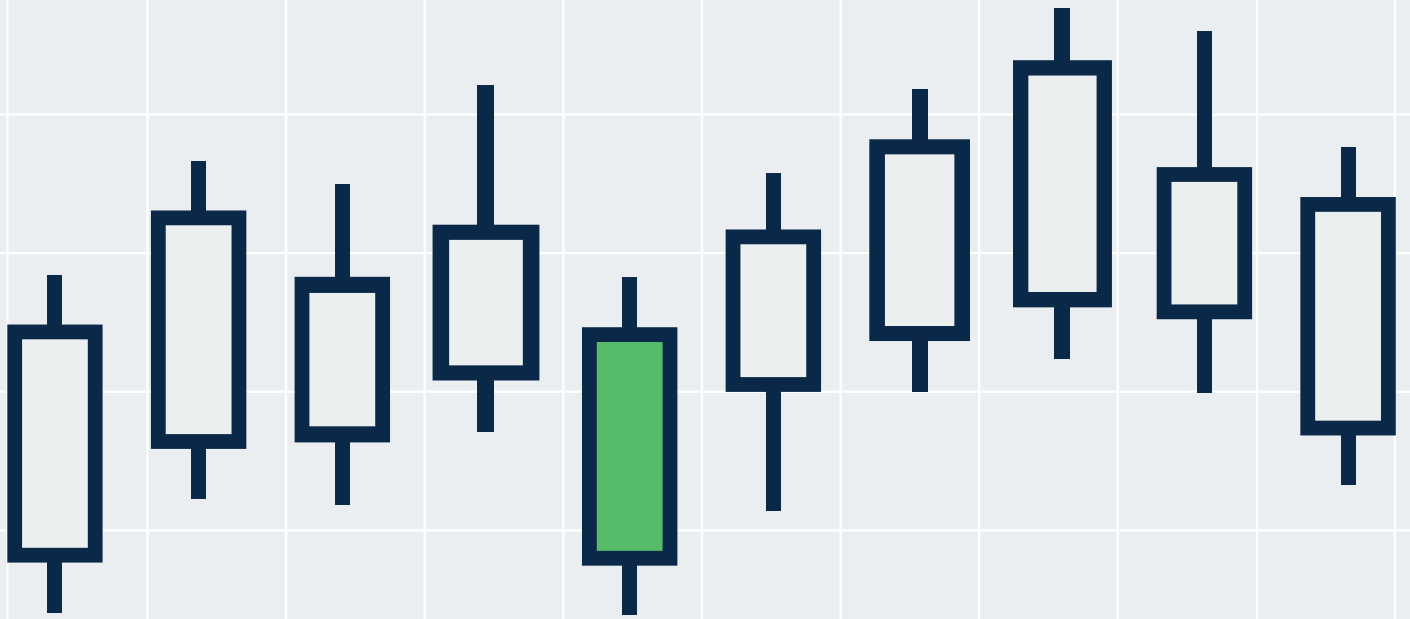
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No Monkey Business

• **TWO TERMS**—stimulus and group-think—may have injected optimism into the markets. But in an already-raging bull market, excess optimism warrants caution. As the “reopening trade” signaled pent-up demand for anything associated with leaving our homes and returning to “normal” (whatever that means now), we saw bouts of euphoria in the markets. And it caught the attention of traders and Wall Street. Although some will say what we’ve seen looks like the late 1990s before it all burst, history doesn’t necessarily repeat itself. But it can open the floodgates for a new breed of traders chasing the next set of story stocks.

And that’s the rub with the stock market—you never really know where the truth lies in relation to value. Get too complacent and the market can turn against you. No matter what so-

cial media is murmuring or the pundits are spewing, there’s no substitute for due diligence. Trading decisions as well as long-term investing choices need to align with your financial goals. It’s really about your relationship with the market and knowing what triggers a trading signal for you. And before you forge ahead, it’s important to have an exit plan in place.

Easier said than done? The good news is there are several ways to do this. Think about what’s important to you and how to achieve it. What type of risk management strategies align well with your goals? Maybe you use charts and place stop orders based on breakout levels, Fibonacci retracements, or trendlines. In the heat of the moment, it’s easy to lose your focus. You could turn a perfect setup upside down and end up with a loss. What could possibly happen to your can’t-lose, six-indicator, oscillation-channeling-stochastinator setup? Take a look at “The Five Biggest Charting Mistakes You’re Probably Making” on page 16. These tips could go a long way to help you avoid making embarrassing charting faux pas.

We spend a lot of time thinking about what to do when a trade goes wrong, but what if your trade’s going right and reaches its profit target? Should you get out even if you think you could squeeze some more returns from the trade? Gut instinct is cool if it got you here, but lightning rarely strikes twice. You can flip to “How to Exit a Trade (Without Losing Your Mind)” on page 20 to learn some options strategies that could help you lock in profits without leaving money on the table.

Savvy traders embrace volatility and whatever the markets offer them. Part of their plan is to actually have a plan and stick to it. Exuberant markets can be fun on the way up, but in the end, it’s not about how much you make; it’s about how much you keep. Plan your exits, win or lose, and you’ll be ready to trade the new normal.

Happy trading,
Kevin Lund
Editor-in-Chief, *thinkMoney*



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2

Transaction costs are important factors and should be considered when evaluating any options trade. For simplicity, the examples in these articles do not include transaction costs. At TD Ameritrade, online options orders are \$0.65 per contract. Orders placed by other means will have higher transaction costs.



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IN THE MONEY

INDUSTRY SPOTLIGHT

When Short and Long Term Collide: Energy Complex(ities) for 2021 and Beyond

Was 2020 an inflection point for energy, and if so, what's next?



• THERE'S AN OLD SAYING IN TRADER circles: Don't approach a short-term trade with a long-term view—and vice versa. The idea behind it: In the short term, prices move on today's dynamics—economic cycle, momentum, and so forth—and in the long term on fundamental shifts.

But if you go out on a long enough timeline, the short term becomes the long term. And for a trader, it's important to identify those inflection points. Why? If you're trading on momentum, sometimes the long-term trend can act as a tailwind if it's in sync with your short-term momentum trade.

A LOOK AT THE ENERGY MARKET

On the surface, last year might have looked like an inflection point. Consider:

- The crude oil market nearly collapsed at one point during the pandemic.
- Companies that make electric vehicles (and the batteries that power them) attracted massive capital flows.
- Alternative energy indices such as the S&P Global Clean Energy Index (SPGT-CLEN) continued to forge ahead to new highs, while Energy was the cellar dweller.

Some may call last year “the year of the disruptor.” Anything that looked to upend the

old order attracted attention—and capital. And now, with a new administration—one that will likely take a friendlier view of alternative energy—it could mean headwinds for oil drilling and exploration.

But there's a difference between intentions and realities, and again, the short and long term. In the short term, the focus is still on controlling a pandemic, distributing a vaccine, and keeping the economy afloat in the process. Long-term energy trends will likely take a back seat—and stay there for a while.

As of this year, there are roughly 300 million cars registered in the United States, and all but about 1% of them have internal

TOOL TIP

VIEWING TERM STRUCTURE

On the thinkorswim® platform from TD Ameritrade, go to **Charts > Product Depth**, and under the **Curves** subtab, select **All Series**.

combustion engines. Plus, even those electric vehicles run predominantly on fossil fuels—about two-thirds of electric power in the United States is derived from the stuff pulled from the ground.

Meanwhile, CME Crude Oil futures (/CL) have been relatively stable in the mid \$40s per barrel since summer

2020 and even broke above the \$50 level in January 2021. The Energy sector had some upward momentum off the lows as well. So, you don't want to ignore the short term since it could mean missed opportunities.

If an investor trades oil on the technicals, there's nothing wrong with the status quo game plan. Watch the supply and demand dance, levels of support and resistance, and the occasional breakout—and trade the market as you see it.

For a longer-term view, look to an index such as the S&P 500 Energy Select Sector Index (IXE) and subindices such as the S&P Oil & Gas Exploration & Production Index (\$SPSIOP). What's the overall trend of stock prices of oil and gas companies? Are there new regulations in the pipeline, and if so, how far into the future have they been deferred?

Also, take a look at the term structure of /CL. You can see the futures curve going out 10 years, which could give you an idea of how the market is pricing in the long term.

While there may be a long-term shift toward alternative energy, in the short term there may be opportunity in the oil complex. —Words by DOUG ASHBURN

Doug Ashburn is not a representative of TD Ameritrade. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc.

For more on the risks of trading and trading futures, see page 35, #1&3.

THINKTANK

What If...?

There are many ways a trade can play out. How do you prepare yourself? You might consider Price Slices, thinkBack, and OnDemand.

It's easy to get attached to certain features on our phones, cars, or gaming software. The downside—we become oblivious to features we never use. We may not need them. But what if they made our lives simpler or gave us a different perspective? After all, they were invented for a reason.

Think of your “go-to” features on the thinkorswim® platform from TD Ameritrade. Maybe you use the **Option Chain**, **Today's Options Statistics**, and **Positions and Simulated Trades**. Why not go beyond your comfort zone and try other tools on the **Analyze** tab that could take your options analysis up a notch? Three to consider: **Price Slices**, **thinkBack**, and **OnDemand**.

Price Slices

Ever seen this below the Option Chain? Know what it does? In a nutshell, it answers the question, “How much is your trade likely to make or lose if the underlying moves by some amount?” In effect, it helps you run through different “what-if” scenarios.

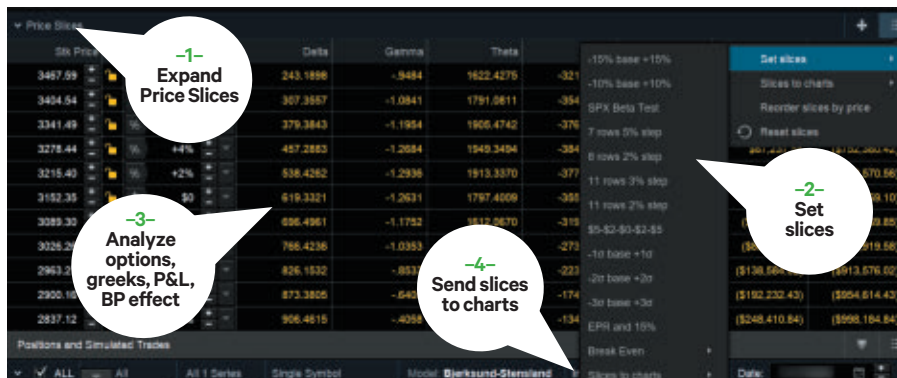


FIGURE 1: SLICE AND DICE. On thinkorswim, the Price Slices tool can be found below the Option Chain. Source: thinkorswim from TD Ameritrade. For illustrative purposes only.

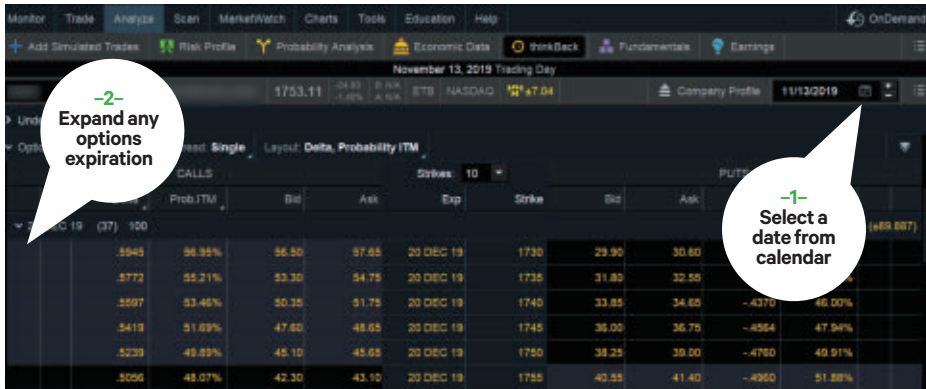


FIGURE 2: GO BACK IN TIME. The thinkBack feature is a subtab under the Analyze tab on thinkorswim. Source: thinkorswim from TD Ameritrade. For illustrative purposes only.

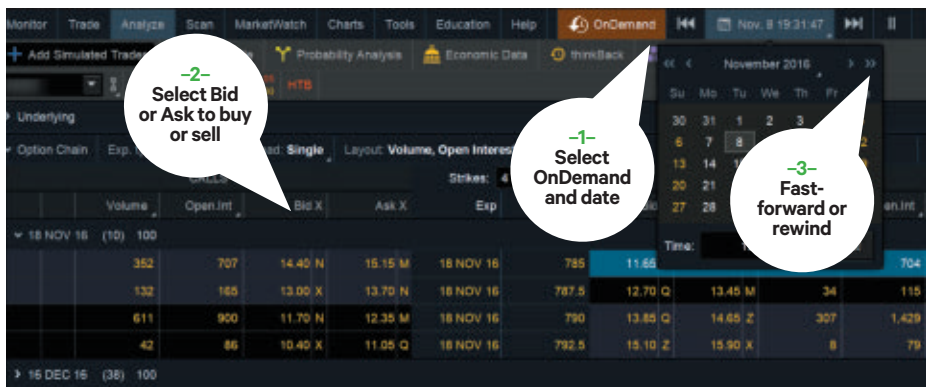


FIGURE 3: TICK BY TICK. Rewind and binge-watch options trades as they played out with the OnDemand feature (found under the Analyze tab) on thinkorswim. Source: thinkorswim from TD Ameritrade. For illustrative purposes only.

You can create as many price slices as you want and set them based on different variables (see Figure 1).

- 1 – Enter symbol and expand **Price Slices**.
- 2 – Select the **Price Slices** menu and set slices based on percentages, dollar value, and standard deviations, among others.
- 3 – Analyze the options greeks, profit and loss (P&L) at the open, P&L for the day, and buying power (BP) effect.
- 4 – Send these slices to the chart of any stock you’re analyzing.

How do you select the slices? You could go back in time and identify significant price levels. Although the past isn’t a pre-

dictor of future price movement, it could act as a guide to help you prepare for different market scenarios.

thinkBack

Along the top of the **Analyze** tab, you’ll find the **thinkBack** subtab. At first glance it looks similar to the **Add Simulated Trades** subtab. The big difference: You’ll see end-of-day options going back 10 years (see Figure 2).

- 1 – Enter a symbol. From the calendar on the upper right, select the date you want to see.
- 2 – Expand any expiration to see the strike prices, especially those that line up with the price slices.

Use thinkBack to test different options strategies and imagine what you would’ve done if certain scenarios played out.

OnDemand

This is another tool that lets you look backward. OnDemand is different in that it can replay all data on any day from December 7, 2009, to the present day. You can go back and watch any stock, index, future, or option, tick by tick, as it happened. And you can trade right along with it, using virtual money. It gives you an account with a virtual balance of \$100,000 so you can enter simulated trades based on the replayed prices and see the P&L change.

The **OnDemand** icon is found at the top right of every thinkorswim tab (see Figure 3).

- 1 – Enter a symbol, then select the icon and go back to any date.
- 2 – From the **Option Chain**, select a bid or ask to buy, and sell just as if you were trading in real time.
- 3 – Fast-forward or rewind the data.

When you’re done, select **OnDemand** again to go back to your live trading account.

Give these tools a try. They could be a conversation starter when you next chat about trading options.

Results presented in analytical trading tools such as Price Slices, thinkBack, and OnDemand are theoretical. Successful virtual trading during one time period does not guarantee successful investing of actual funds during a later time period as market conditions change continuously.

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Making Exceptions: Buying Options Instead of Selling Them

Sometimes trying different strategies can open up new perspectives. We asked Brent Moors, education coach at TD Ameritrade, to shed some light.

We often hear about traders selling options. But why (or when) might a trader buy options?

It's true that selling options has many benefits, but there are times when it may make sense to buy options.

Traders might use long calls and puts to make more efficient use of a portfolio's capital (versus buying stock outright) to attempt

to take advantage of a directional move in the underlying. If the stock makes a strong move in the direction you're hoping for, its underlying options are likely to make a significantly larger percentage move.

For example, a 5% rise in a stock may mean a 50% increase in the price of a call option. A 5% drop in the underlying may mean a 50% increase in a put option.

The lower cost of the options versus buying an equivalent amount of the underlying can translate to capital efficiency. For example, this could be a benefit when long puts are used to help protect a stock or an entire portfolio against a down move in the underlying stock.

Long options can also benefit from spikes in **implied volatility (IV)**. Long options are **vega** positive. This may be advantageous in the case of long puts, because when there's a strong drop in the underlying, IV will likely rise. The long put trader can benefit from favorable **delta** and **vega** effects. Bottom line: The sensitivity to volatility changes might mean you can use long options when you anticipate large volatility moves.

But these benefits also have another side to them: IV can drop and make it even harder to make money.

Then there's **theta** lingering in the background that can work against you. But you may be able to minimize theta damage. Theta is generally higher closer to the expiration date and when it's closer to being **at the money**. So you could buy options that are further out until expiration, shorten the holding period of the contract, and buy contracts that are further **in the money (ITM)**.

Is there a way to figure out how much impact a change in the underlying stock price may have on the options price?

The Theo Price tool on the thinkorswim® platform from TD Ameritrade could help. You

TRADER GLOSSARY
TURN TO
PAGE 33

can find it in the **Option Chain** under the **Trade** tab. Select **Theo Price, Mark** from the **Layout** menu, then select **Theo**

Price. This opens a menu where you can make theoretical adjustments to the stock price. In the Option Chain you can see what the theoretical price of the option might be.

By changing strike prices and expiration dates, you can help control how much risk to take when buying options. Generally, the more ITM a contract is and the further out until expiration, the more expensive it'll likely be.

Options buying can be an important part of your tool chest. In general, these tips can help you navigate the world of long options:

- **Have rules for entries and exits.** Plan ahead and don't let emotions rule your trading.
- **Remember that long options are speculative.** Because of the effects of theta, you're fighting against time and need the underlying stock to move in your direction within a certain period of time. If the underlying stock price moves opposite of your expectations, the long options position will likely expire worthless, resulting in the loss of your entire investment in that option.
- **Education is key.** Options trading in general, and long options trading in particular, is subject to significant risk and isn't appropriate for everyone. Know what you're doing before you begin trading options.



Snap Your Price

Identify the open, high, low, and close instantly with the Crosshair Snapping tool.



BRENT MOORS
EDUCATION COACH
TD Ameritrade

• How often have you tried to get your chart crosshair to point precisely to the level you want, yet failed? Blame it on the notification that popped up and made your hand slip. Well, that's no longer an obstacle thanks to the Crosshair Snapping tool. It allows you to "snap" the crosshair to a desired price.

(Note that this feature works only when the cursor type setting below the chart on the bottom right is set to cross, horizontal, or vertical. It won't work if "none" is selected.)

Here's how it works. Under the **Charting** tab on thinkorswim® from TD Ameritrade:

- 1** - Select the settings icon at top left (the gear wheel).
- 2** - Select **Appearance**.
- 3** - In the **Snap Crosshairs** drop-down menu under **Common**, select **None**, **Open**, **High**, **Low**, **Close**, or **OHLC**.

The crosshair will automatically snap to the applicable price for the given aggregation period. It doesn't matter if the chart is a bar, candle, line, or any other type.

How can this feature be applied to trading? If you want to set a stop order just below

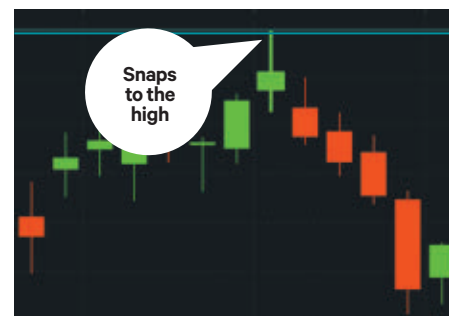


FIGURE 1: CROSSHAIR SNAPPING TOOL IN ACTION. When you select any price bar, the crosshair snaps to your desired data point. On this chart, the crosshair snaps to the high of the bar.

Source: thinkorswim from TD Ameritrade. For illustrative purposes only.

the day's low price of the day, the Crosshair Snapping tool could quickly identify that level.

Identifying price levels is important for spotting support or resistance areas, pivot points, retracement levels, and so on. But to precisely place the cursor on a specific price level can be difficult—shaky hands, an over-responsive mouse, or clumsy finger errors can cause the cursor to slip. The Crosshair Snapping tool expedites the process and requires less precision in cursor placement. It identifies these levels quickly.

For example, if you select **High**, the tool will snap to all those data points (see Figure 1). There's no need to make sure you have a steady hand on a specific price bar while simultaneously reviewing price data across the top of the chart to identify all data points.

Option traders can benefit from the tool as well, especially to identify potential strike prices for options contracts. If, for example, a put seller wants to sell a contract below a recent low price of a stock price bounce, the Crosshair Snapping feature can quickly identify that low.

SO NEXT TIME YOU'RE TRYING TO IDENTIFY price-bar data, save yourself the frustration and set up the Crosshair Snapping feature on your chart settings. When you see the precise data displayed on the price axis, think about where to place your entries, exits, and strike prices. It can shave a few seconds off your chart analysis. May not seem like much. Yet, a few seconds can add up, especially if you look at several charts in a trading day.

For more on the risks of trading and trading options, see page 35, #1&2.



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SKILL

LEVEL

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TAKE AWAY:

How to avoid the more common charting errors.

THE



BIGGEST CHARTING
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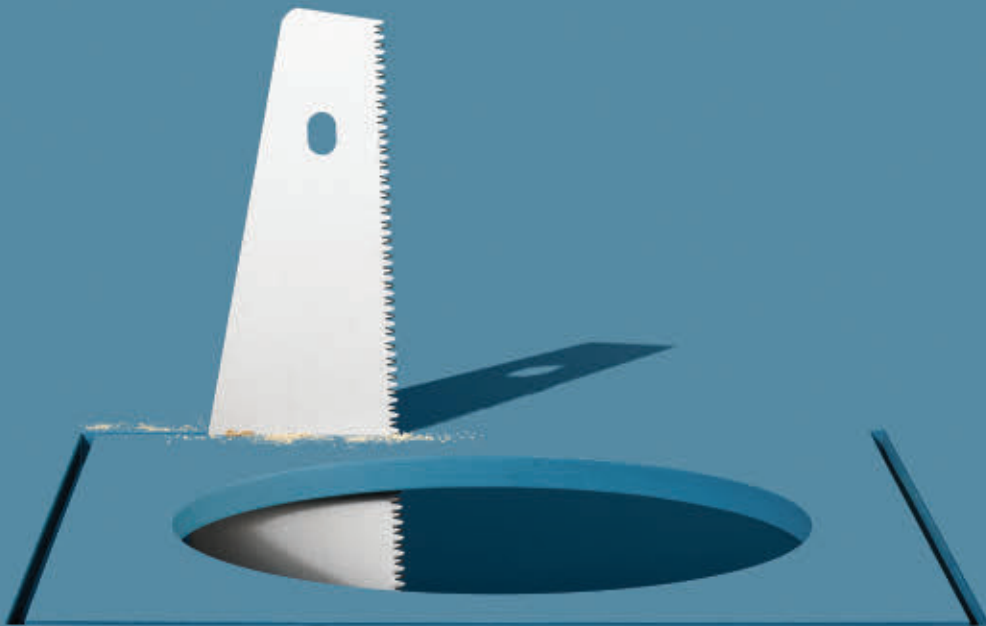
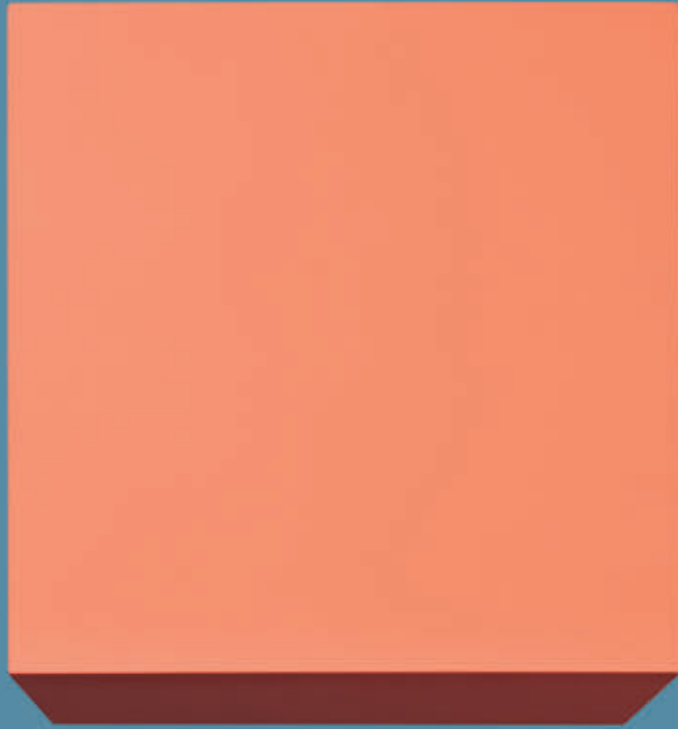
BIG IDEA:

WHETHER YOU FIRST STARTED CHARTING STOCKS ON PAPER, SOFTWARE, OR A SMARTPHONE, YOU'RE LIKELY TO MAKE THE SAME MISTAKES. HERE'S HOW TO AVOID FALLING INTO TYPICAL CHARTING TRAPS.

WORDS BY **JAYANTHI GOPALAKRISHNAN**



PHOTOGRAPHS BY
DAN SAELINGER



To err is human.

And to do so in your trading platform doesn't take much. Entering an incorrect stock symbol, adding an extra zero to the order quantity, or interpreting a chart incorrectly—these are all ingredients for impressive trading mistakes.

All errors aren't created equal; some may have easier fixes than others. Technical analysts have a unique challenge because there's no right or wrong way to analyze charts and multiple ways to interpret them, leaving the field wide open.

CHARTING TRAPS TO AVOID

A momentum trader may want to see a strong breakout before jumping into a trade. A trend trader, on the other hand, might look for a breakout confirmation. And a short-term trader may only be interested in volume thrust.

When looking at a price chart, the desire to jump into a trade could surge at the first sign of things going your way. If luck's on your side, the trade could work out. But fake outs happen. How many times have you succumbed to enter a trade only to find out later that you didn't read the chart correctly?

Although there's no right or wrong way to parse a chart, consider five charting mistakes that deserve a place in the Charting Bloopers Hall of Fame.

1 YIKES! YOU'VE GOT IT BACKWARD

Say you've fired up your thinkorswim® platform from TD Ameritrade and are looking at a stock chart. You see a clear low point, and a few months later, a clear high point. You want to figure out where to enter a trade, so you add Fibonacci retracement levels to help see the support and resistance levels. You bring up your drawing tools, select the % symbol, and drag the tool from the high point to the low point. Oops! There's a problem. The high point is to the right of the low point. You're supposed to draw Fibonacci retracements from left to right, and in this case, that would be from low to high (see Figure 1).

It may not be the worst thing in the world. The retracement levels would be the same, but the percentages would be reversed. So instead of saying price is at the 23.6% retracement level, you might say price is at the 78.6% level. Why risk sounding like you may not know charts as well as you think you do?



FIGURE 1: FIB RETRACEMENTS GO FROM LEFT TO RIGHT. On the thinkorswim platform, select **Drawings > Drawing Tools > % (Fibonacci Retracements)**. Place the tool at the low point and drag it to the high. This displays the different retracement levels you see on the chart (yellow horizontal lines). Source: thinkorswim from TD Ameritrade. For illustrative purposes only.

Another common chart error is drawing trendlines on the wrong end of the price bars. The common rule is in an uptrend, draw trendlines that touch the lows, and in a downtrend, draw trendlines that touch the highs. It can be hard to remember because the natural tendency is to think highs when you think of uptrends and lows when you think of downtrends. In a sense, it's counter-intuitive. But do it for a while and it'll become second nature.

ment level, you might say price is at the 78.6% level. Why risk sounding like you may not know charts as well as you think you do?

2 ANALYSIS PARALYSIS: NOT KNOWING WHAT TO DO

Sure, there are tons of indicators, drawing tools, and chart patterns to choose from. You can get dizzy trying to figure out which ones to use. Sometimes, you'd rather procrastinate, which means you miss out on promising trades. Other times, you're too afraid to trade and would rather not make any decisions. Or perhaps you suffer from "analysis paralysis" and don't want to hit a buy or sell button. Overcoming these feelings can be tough. But if you're determined to conquer these behaviors, consider implementing a methodical approach to tackling the markets.

The good news? There are tons of ways to do this. You could set up a system where you scan for stocks that meet specific criteria, analyze those charts, then narrow your choices.

GET STARTED

HOW TO

Want to set up a trading system? Check out this approach: "Technical Analysis and Charting: How to Build a Trade": <http://bit.ly/TT-BldTrd>

LEARN

Looking for specific chart patterns? Learn about momentum patterns here: <http://bit.ly/TT-MomoTrd>

3 INDICATOR PALOOZA: RESIST THE URGE

When you look at a chart, do you want it to tell you what you want to hear? If so, you run the risk of placing too many indicators or patterns on a chart. And if you have too many indicators, you may end up misreading the indicators or chart patterns.

One solution could be to create a set of core indicators that look at different types of price action. For example, you could break down the indicators into four categories: price action, trend following, momentum, and an overall indicator (see sidebar: "Too Hot, Too Cold. What's Just Right?").

4 DON'T GET SKIMPY: BE BALANCED

Maybe minimalism is your schtick, but too few indicators could generate false signals. Because there's no certainty in signals generated by technical indicators, it's important to have just enough indicators to get confirmation signals. For example, if you base trading decisions on moving averages, which may have worked well during an extended bull market, there may come a time when the indicator may no longer work well. The trend could slow down, pull back, or even reverse.

Moving averages are lagging indicators; by the time you get a trading signal, the market may have already changed direction. Remember that markets are dynamic, so it's not a good idea to get comfortable using one or two indicators. A good mix is likely to alert you of a change earlier rather than later.

5 VIVA LA VOLUME! DON'T IGNORE IT

Price movement without volume can be meaningless. When momentum is in vogue, you're likely considering stocks that have enough volume to move them up or down. Volume bars are a popular way to see how much trading is taking place. But there are some volume-related indicators such as on-balance volume or accumulation/distribution you could also consider. Then ask yourself these questions: When price is moving up or down, is volume also going up? When a price bar breaks out, is it accompanied by high volume? Do you notice any unusual volume spikes?

A GOOD FIX FOR THESE COMMON CHARTING mistakes is mindful awareness. As you know, markets change, sometimes quickly, which might make you act irrationally. Yet, being aware of errors could help you approach the markets with a calmer, more logical mind—one that's ultimately wired to make fewer mistakes.

Jayanthi Gopalakrishnan is not a representative of TD Ameritrade, Inc. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc.

For more information on the risks of trading and trading options, see page 35, #1 & 2.

TOO HOT, TOO COLD. WHAT'S JUST RIGHT?

No two chartists will look at charts the same way. What you put on a chart depends on your trading style. The thinkorswim platform has more than 300 indicators to choose from. To browse them, select **Studies > Add Study**. Browse different categories and try out different indicators. You may find some useful ones you never knew existed. Here's an example of how you could organize indicators into different categories:

Price action—Candlestick bars / Support and resistance levels / Fibonacci retracement levels

Trend following—Trendlines / Moving averages / Moving average convergence divergence (MACD)

Momentum—Stochastic / Relative Strength Index (RSI)

Overall market indicator—Bollinger Bands®

On the candlestick chart in Figure 2, Fibonacci retracement levels (drawn from a top [left] to a low [right]), volume, and Bollinger Bands are overlaid on the price bars. The RSI, which measures momentum, and MACD, a trend-following indicator, are added as subcharts.

A FEW OBSERVATIONS:

1. After hitting the low in mid-March, price started moving up toward the middle Bollinger Band. At the same time, price crossed above the 23.6% and 38.2% Fib retracement levels (and got pretty close to

the 50% level). Momentum started moving up, as seen in the upward-trending RSI. The MACD crossover also indicated the trend reversed from down to up. Volume was relatively high during this time.

2. A short-term modest pullback followed as prices continued moving along the middle Bollinger Band and prices moved back toward the 23.6% Fib retracement level. The RSI looked to be trending lower, but MACD continued moving up. Volume decreased toward average levels.

3. We then see a reversal, with prices moving back toward the upper Bollinger Band and traveling along that upper band for a couple of weeks. Prices moved up to the 61.8% Fib retracement level, and RSI and MACD were trending up. Volume was at average levels.

4. In late April, the trend slowed down, with prices pulling back toward the middle Bollinger Band and 50% Fib retracement level. RSI and MACD were relatively flat, and volume was lower with some unusual spikes. The stock was stuck in a trading range.

5. It wasn't until early June that we saw some activity to the downside. Price moved back toward the lower Bollinger Band, which coincided with the 50% Fib retracement level. Volume spiked on the down move, RSI saw a significant drop, and MACD was slowly trending lower.

When all indicators suggest the same action, this might help you make more confident trading decisions.



FIGURE 2: NOT TOO FEW, NOT TOO MANY. On the thinkorswim platform, select the **Charts** tab and enter a symbol to bring up a chart. Then add your core indicators or studies from the **Studies** subtab. Choose indicators from different categories. Here you see Fibonacci Retracement levels, Bollinger Bands, volume, RSI, and MACD. Source: thinkorswim from TD Ameritrade. For illustrative purposes only.

TAKE AWAY:
*Manage options
positions with these
different exit strategies.*

HOW TO



PHOTOGRAPHS BY
DAN SAELINGER

A TRADE

WITHOUT LOSING

YOUR MIND

BIG IDEA:

GETTING OUT OF A TRADE WHEN YOUR GUT TELLS YOU THERE'S ROOM TO RUN CAN BE AGONIZING. BUT THE QUESTION OF WHETHER TO STAY IN OR GET OUT DOESN'T HAVE TO BE BINARY. THERE ARE OTHER WAYS TO TAKE YOUR RISK OFF WITHOUT GIVING UP ON MORE. WORDS BY **JAY KAEPPEL**



There's a great scene in the movie *All the Money in the World* when Fletcher Chase asks J. Paul Getty how much money it'd take to make him feel secure. To which Getty replies, "More."

Not surprisingly, this is often how you'll feel when staring at a profitable trade and wondering whether to keep your line in the water to potentially eke out some more gains or cut bait and move on. Unfortunately, gut trading isn't typically a great strategy in the long run.

In a sense, deciding when to get in to a trade is easy. Sure, there's lots of analysis to be done to decide which trade to take, but for most traders, the desire to "make money" can be pretty compelling on its own. Yet, when it comes to deciding when to exit a winning trade, the desire to make "more money" when things are going swimmingly can be a bit too alluring and often has consequential effects.

The next time you find yourself in a winning trade and think you can squeeze a little more, consider a few strategies to hedge your profits and leave a fixed amount of money (or rocks) on the table.

PLAN AHEAD

Because buying options is naturally more complex than buying stock—due to price, time, and volatility—exiting trades can be equally complex if you feel there's still room to run. Essentially, it comes down to three choices:

- 1 – Do nothing
- 2 – Exit completely
- 3 – Realize partial profits and/or modify the trade

Using a long call position, let's break 'em down. See Figure 1 for the risk graph of a long call.

When to Do Nothing.

If you buy a call with a profit target and/or time frame in mind, it might make sense to simply let your expected scenario play out until either your profit target or time frame are hit. For example, say you buy a call option

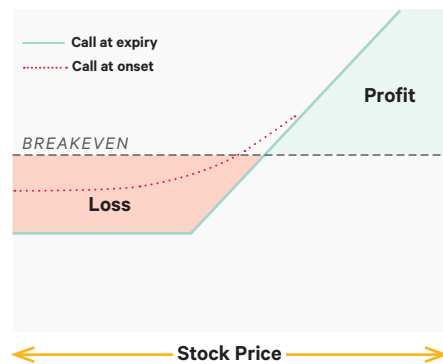


FIGURE 1: LONG CALL. For illustrative purposes only.

expecting the underlying security to advance 10% in the next two months. One week later, the underlying is up 4% and you have a decent profit on the call option. If your goal is to maximize the profitability associated with a 10% move within two months, it may be time to steel your spine and simply let the trade ride to achieve your original goal.

When to Exit Completely.

If you entered a long call based on a specific profit target or profit range for either the options position or the underlying security, and you hit either target, then it makes perfect sense to cash out and exit, sticking to the plan you already laid out. But there's a third option.

When to Take Partial Profits and/or Modify.

When your conviction is that the underlying trend is strong and may continue, taking partial profits and/or modifying your position could allow you to improve the overall reward-to-risk trade-off. More specifically,

modifications are often done to lock in profit and/or mitigate risk, while retaining the opportunity for more gains.

What's important to note is that when you modify a trade, you're essentially putting on a new trade. Therefore, before doing so, make sure you're doing the same due diligence on the "new" trade that you did getting into it in the first place. Are the same factors still in play? If not, you may want to think about getting out entirely and moving on to a new opportunity.

HOW TO MODIFY LONG CALLS

Let's jump out of theory and into a mock trade. Suppose stock XYZ is trading at \$50 per share, and you buy 10 call options on XYZ at the \$50 strike for \$3 (totaling \$3,000 in capital).

From there, XYZ rallies to \$56 per share, and in the process, the 50-strike calls climb to \$7. You're now sitting on a \$4,000 profit (minus any commissions and contract fees). If you think XYZ will continue to rally strongly, you can:

- 1 – Do nothing, hoping the stock keeps climbing as well as your call.
- 2 – Cash out and sell the 10 calls, cash in on the \$4,000 profit, and move on.
- 3 – Realize some profit and/or modify the position.

However, there are two considerations to keep in mind when deciding to modify a trade: not wanting to walk away from the stock completely and not wanting to risk giving back the entire windfall profit if the rally fizzles and XYZ reverses.

What are some possibilities?

NUMBER 1

Sell Half

Once an option doubles in value, you can sell half of your original position and lock in a break-even trade at worst. Let's consider this possibility. In our example, say you:

- Bought 10 @ \$3
- Then sold 5 @ \$7

By doing so you've protected your original investment and banked \$500, while hanging onto five of the calls (the remaining \$3,500 in profit). If the rally continues, and the calls continue to increase, so does your profit.

On the other hand, XYZ could gap down below 50 overnight and render the five remaining calls worthless. In this scenario, you still lock in a \$500 profit. Gaps aside, however, much of the time you can set a stop underneath your options price (say, 50% below current price), which could still give you a nice gain overall, depending on what price you actually exit at when your stop order triggers.

NUMBER 2

Sell Half and Spread the Rest

Using the same trade, you think XYZ could continue to rally up to \$60 per share. You could again sell half of your calls at \$7, take the original risk off the table, bank the \$500, and turn the remaining calls into a **vertical spread** by selling higher-strike calls on those that remain (see Figure 2). If the 60-strike calls are going for, say, \$1.50, that's an additional \$750 you can bank now (5 x \$150) without adding more risk to the trade. You've now locked in a total profit of \$1,250, even if the stock falls to zero at this point.

Now, suppose XYZ continues to rally and closes at \$60 on expiration day. You end up with a net profit of \$6,250 as follows:

- Ten 50-strike price calls bought @ \$3 each
- Long five 50-strike price calls sold @ \$7 each (profit of +\$2,000)
- Long five 50-strike price calls worth \$10 each at expiration (profit of +\$3,500)
- Short five 60-strike price calls expire worthless (profit of +\$750)

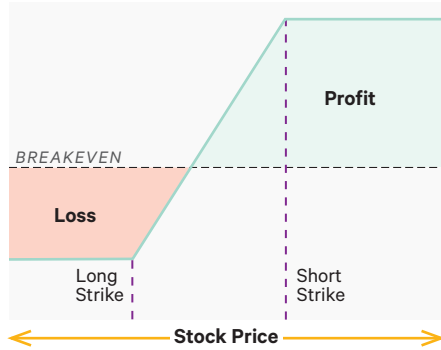


FIGURE 2: LONG CALL VERTICAL. For illustrative purposes only.

But if XYZ closes at \$50 per share at expiration, as mentioned, you still end up with a net profit of \$1,250 as follows:

- Ten 50-strike price calls bought @ \$3 each
- Long five 50-strike price calls sold @ \$7 each (profit of +\$2,000)
- Long five 50-strike price calls expire worthless (loss of -\$1,500)
- Short five 60-strike price calls expire worthless (profit of +\$750)

With XYZ shares above \$60, the profit is capped at +\$6,250. For each \$1 increment below \$60 per share to \$50 per share, the profit declines by \$500. With XYZ shares at \$50 or below, the worst-case scenario is a profit of +\$1,250.

NUMBER 3

Roll Up (to a Higher Strike Price)

Let's go back to something we touched on earlier. You're sitting on a \$4,000 unrealized profit. You don't want to risk giving it all back—but you believe there's a good chance the rally in the underlying will con-

tinue. There's a super simple modification you can make called "rolling up." To roll up simply means to sell calls you now hold and use some or all of the proceeds to buy lower-priced calls at a higher strike price.

The 50-strike calls you bought for \$3 are now trading at \$7. During this time, the underlying stock has risen from \$50 to \$56 per share. A simple roll up might look like:

- Sell 10 50-strike price calls @ \$7
- Buy eight 55-strike price calls @ \$3.75

Let's consider the net effect of this simple adjustment:

- You bank a \$4,000 profit in the 50-strike price calls.
- You spend \$3,000 to buy eight 55-strike price calls (\$3.75 x 8 calls x 100 shares).

The worst-case scenario—if XYZ stays below \$55 through options expiration, you're left with a \$1,000 profit from the sale of the 50-strike calls. However, if the stock keeps rallying, you could have unlimited potential, while your original risk and a decent profit are now "off the table."

THE GOOD NEWS IS THAT OPTION traders have many possible choices. The bad news is that too many choices can lead to confusion and indecisiveness, and at times, frustration. This is why it's critically important that you have a plan when you enter each trade regarding which criteria would trigger you to exit the trade completely and under what circumstances an adjustment to the original trade could lead to an improved reward-to-risk trade-off.

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SKILL

LEVEL

PRO

TAKE AWAY:

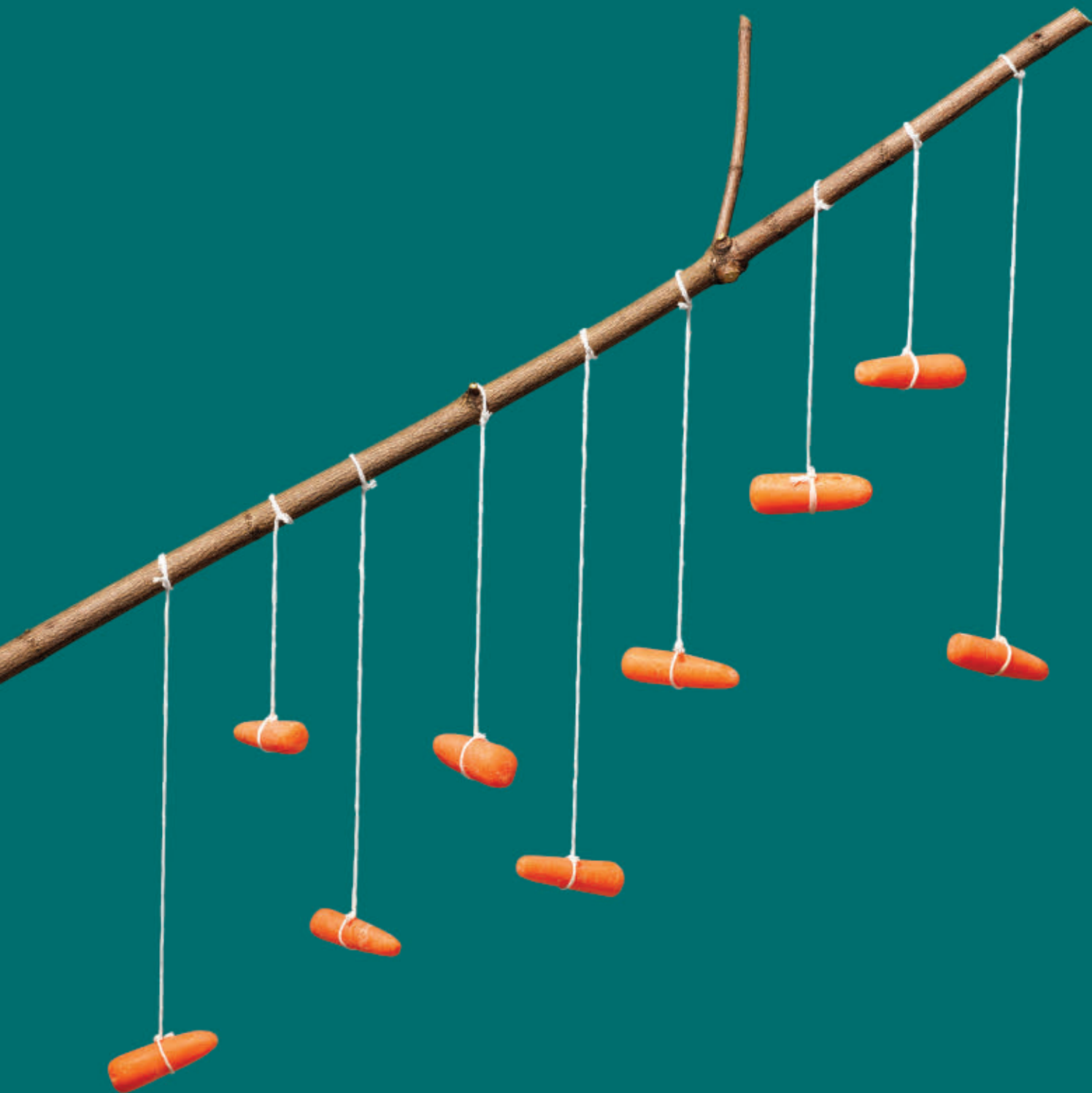
Dynamically hedge a long options position to help pay for theta.

GOT VOL?

PHOTOGRAPHS BY
DAN SAELINGER

TRADE AROUND IT

BIG IDEA: DO THE HEADWINDS OF TIME DECAY TURN YOU OFF FROM BUYING SINGLE OPTIONS ON STOCKS THAT MOVE AROUND A LOT? WHAT IF YOU COULD TURN THAT HEADWIND INTO A TAILWIND BY TRADING THOSE STOCK MOVES? TURNS OUT YOU CAN. WORDS BY **DOUG ASHBURN**





Find yourself trading the same strategies over and over? Sometimes mixing things up and learning about other strategies doesn't hurt. Take **straddles** for example. There are times when an option looks like a buy—not from a directional standpoint but in terms of volatility (vol). The stock may have been fluctuating, and you think it's priced cheap relative to its historical vol and daily price moves. So, you might want to get long vega by buying an **at-the-money** (ATM) straddle. You'd choose the ATM strike because it's the point of maximum **vega**, plus it's delta-neutral—the 0.50 **delta** from the ATM call is offset by the put's -0.50 delta.

Yet, buying and holding a straddle is risky. Not only do you have the vega risk—just because vol is low doesn't mean it can't go even lower—but you've also got time working against you in the form of **theta**, i.e., time decay.

The theoretical value (TV) of an option is based in part on how much the price of the underlying stock is likely to move between now and expiration. The less time left until expiration—theoretically, anyway—the less opportunity for movement. So all things being equal, the price of a long option loses value with each tick of the clock.

When you sell an option, theta acts as a strategy tailwind. But with long options, it's the opposite. So for that long ATM straddle, the negative-theta meter starts running once you place the trade.

But there's a positive side to negative theta: **gamma**. And if you're long an ATM straddle in anticipation of a vol spike, gamma might be the key to help offset a theta drag while you wait.

THE GAMMA/THETA TRADE-OFF

When stock prices move, options prices also move by an amount roughly equivalent to the

XYZ Price	60-Strike Call Value	Call Delta	Gamma	Theta	60-Strike Put Value	Put Delta
\$58	\$1.19	0.31	0.08	0.04	\$3.19	-0.69
\$59	\$1.55	0.40	0.09	0.05	\$2.55	-0.60
\$60	\$2.00	0.50	0.10	0.06	\$2.00	-0.50
\$61	\$2.55	0.60	0.09	0.05	\$1.55	-0.40
\$62	\$3.19	0.69	0.08	0.04	\$1.19	-0.31

TABLE 1: THEORETICAL GREEKS OF A DYNAMIC HEDGE. Sample data for illustrative purposes only.

delta. So if a call option has a 0.50 delta, a \$1 rise in stock XYZ would theoretically raise its value by \$0.50. But here's the kicker—as XYZ rallies, so does its delta by an amount known as its gamma. In other words, gamma can magnify the effects of the underlying stock movement on the price of an option (see Table 1).

As XYZ moves from \$60 to \$61, the 60-strike call's TV increases by \$0.55, which is a bit more than its 0.50 delta would suggest. It may help to consider delta over a range instead of a single point. So, from \$60 to \$61 in the underlying, the average delta is $(0.60 - 0.50) / 2 = 0.55$.

Because of gamma, as XYZ rallies, the call's TV rises at a faster rate until it becomes a deep **in-the-money** (ITM) call, with a delta approaching 1.0 until it moves virtually 1:1 with the stock price. And if the stock price drops, the delta decreases as well. Although the call option drops in value as the strike moves further **out of the money** (OTM), it does so at a slower and slower rate until, at some point, its delta is virtually zero.

The same holds true for put options. If you're long an ATM put and the stock goes down, the TV of the option increases at an increasing rate. If the stock goes up, the put's TV decreases at a decreasing rate. That's the power of gamma.

But gamma isn't free. To be long gamma is to be long options, which means negative theta. At any snapshot in time, gamma augments delta and thus TV. But with each passing moment, theta is pushing TV the other way. With options, there's always a trade-off.

NOT JUST FOR THE BIG PLAYERS ANYMORE

Until recently, gamma scalping wasn't a popular strategy among smaller retail traders. To consistently get that "hedge-able" quantity of shares for your gamma scalp, you might've had to take on too large of a position size, or widen your entry and exit points. Otherwise, commission costs would've likely eaten into the net profit per scalp.

TRADING THE GAMMA

Going back to Table 1, suppose you bought five of the 60-strike straddles for \$4 each.

Consider this scenario: Suppose that after you bought the straddles, XYZ dropped to \$59, but then rallied back to \$60 by the end of the day. The TV would've risen from \$4 to \$4.10 and then likely fallen back to \$4. But now that it's the end of the day, all

DISCOVER SYNTHETIC STRADDLES

If you own shares of a stock, you don't need to buy the straddle. Instead, you can get the same exposure by buying two ATM puts for every 100 shares. It's called a **synthetic straddle**. If the stock rallies, you may want to sell a portion of your long shares rather than go short. Short selling can be a messy business, and not all accounts qualify.

things being equal, that negative theta kicks in, dropping TV by \$0.06 per option, or \$60. (Remember, it's five calls and five puts times the multiplier of 100.)

What if you'd bought 100 shares of XYZ when it was down at \$59? After all, it wasn't just the TV that changed when the stock broke; the deltas changed as well—the call from 0.50 to 0.40 and the put from 0.50 to 0.60. Combine them, and that's a 0.20 delta times the five straddles, or 1.00 deltas.

You could've bought 100 shares of XYZ to maintain a delta-neutral position. And when XYZ moved back to \$60, you could've sold the 100 shares you bought, returning again to delta-neutral but with a \$100 "gamma trade" in your pocket (minus, of course, the day's theoretical time decay of \$60 and any transaction costs you may have incurred).

How do you decide where to place your entry and exit points? There are no hard-and-fast rules, but let's review three ideas.

Dollars to cover. In our example, with a theta of 0.06, this position theoretically loses \$60 overnight. So that becomes the hurdle. If you can average at least \$60 per day in gamma trades, you can buy yourself some time while you wait for the vega move you're expecting.

Pair with a technical analysis strategy. If you typically trade technicals, you might use them to help guide your entry and exit points. For example, as XYZ moves in the direction of the primary trend, you might hedge only a portion of your delta and let the rest run. Or, if you near a support or resistance level, you could pick a point just shy of it and flatten your delta.

Trade the standard deviation. Volatility and thus options prices are derived from probabilities of price movement. Without getting too geeky, vol is essentially a measure of annualized



FIGURE 1: STANDARD DEVIATION. Some gamma traders use the daily standard deviation to indicate entry and exit points. Under Analyze > Risk Profile, select $\pm 1\sigma$ and change the date to current day. The price points will display as a shaded box. Source: the thinkorswim platform from TD Ameritrade. For illustrative purposes only.

standard deviation. So, many dynamic gamma hedgers use the daily standard deviation as a place to square up their deltas. But you don't need to calculate it yourself. The thinkorswim® platform from TD Ameritrade can do it for you (see Figure 1).

KNOW THE GROUND RULES AND LIMITATIONS

This strategy is neither for the fainthearted nor the casual participant. You can't just set it and forget it. And because this strategy touches on all the major greeks—delta, gamma, theta, and vega—there are lots of moving parts.

Remember that no greek is constant. As you approach expiration, that theta number gets bigger, and so does the gamma number. At expiration, each option is either ITM or OTM. It's either worth its intrinsic value and exercised, or it expires worthless. So the stakes get higher the closer you get to expiration. Even veteran gamma scalpers may liquidate or attempt to roll their positions before expiration.

Besides, if you're trading gamma as part of a long vega strategy, you'll likely want to move on well before expiration. Theta and gamma intensify as you approach expiration, but vega decreases.

Speaking of long vol, some traders like to let their deltas run a bit more on the upside (and tighten them on the downside), because vol tends to drift downward on market

rallies and drift upward as markets break.

Gamma trading is a complex strategy, but one that can help you get in tune with the interplay among all those greeks. If you can master it, you might develop a deeper understanding of how options prices move. If you're used to trading options from the short side, dynamically hedging around a long options position might broaden your perspective.

IN TODAY'S ONLINE ZERO-COMMISSION environment, you don't need the big guns to be a gamma trader. You can start small with a few contracts per trade. Want to go even smaller? Fire up the paperMoney® platform and gamma scalp risk-free for a few expiration cycles until you get the hang of it.

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The paperMoney software application is for educational purposes only. Successful virtual trading during one time period does not guarantee successful investing of actual funds during a later time period as market conditions change continuously.

SKILL

LEVEL

SAVVY

TAKE AWAY:

Learn how futures work, not just how to trade them.

WRAPPING YOUR ARMS AROUND FUTURES

BIG IDEA: THE FUTURES MARKET CAN OPEN NEW WORLDS FOR OPTION TRADERS, BUT IT CAN ALSO CARRY UNIQUE RISKS. SO BEFORE YOU DIVE IN, KNOW HOW THIS MARKET WORKS.
WORDS BY **BRUCE BLYTHE**

PHOTOGRAPHS BY
DAN SAELINGER



IF YOU'RE

reading this magazine, you've likely been trading stocks and options for a bit and been around the block a few times. But the futures market? Perhaps that's where you've drawn the line. "Thanks, but I'm good" you might be thinking, right?

Understandable. Futures are a different animal. But you may be closer to the futures market than you realize. Did you drink coffee this morning? Buy groceries this week? Refinance your mortgage this year? Guess what: If you said yes to any of these, in a way, you've already been a "participant" of sorts in the futures market.

Trading futures does come with potential benefits, such as diversification and portfolio hedging. But futures trading involves substantial risk and is not suitable for everyone. Like anything else, the more you know, the better. Let's start with some of the basics.

FUTURES CONTRACTS—WHAT ARE THEY?

In a nutshell, a futures contract is an agreement to buy or sell an asset at an agreed price at a specific time in the future. Many of these contracts are based on different commodities—grains, coffee, metals, livestock, sugar, oil and natural gas, or money itself (in the form of interest rate futures).

Futures contracts are "standardized" and have certain specs:

- Quality and quantity
- Unit pricing and minimum price fluctuation (aka tick size)
- Date and geographic location for physical "delivery" of the underlying (most contracts are liquidated before the delivery date; actual delivery never happens at TD Ameritrade)

The specs differ across products (see Table 1). For now, let's focus on three commodities—crude oil, corn, and gold—and two not-so-commodities—stock indices (the E-mini S&P 500 Index) and interest rates (10-year Treasury note/bonds).

Knowing the specs of each product helps you analyze futures contracts. So, when you bring up a futures chart on the thinkorswim® platform from TD Ameritrade, you'll know what a one-point move represents. And to

look at price and volume data, select the **Analyze** tab, enter the futures contract symbol, and the traded futures contracts will appear. To see all actively traded options contracts, expand the **Option Chain** (see Figure 1).

FUTURES VS. EQUITIES

Unlike equities, each futures contract has an expiration date. Beginning traders might fear they'll end up with 1,000 barrels of oil on their doorstep when their crude oil futures contract expires. Although it's good to be aware of delivery, when traders buy a futures contract, they're not necessarily buying the underlying asset—they're simply buying an obligation to buy or sell the asset. But most futures contracts aren't held to expiration. Trades can be closed or rolled into a later month.

Futures contracts are also leveraged; that means returns or losses can potentially amplify. Because margin requirements are typically smaller for futures contracts, traders could control a larger futures position with relatively little money down.

So, what's actually happening when a futures contract is purchased? Traders post a good-faith deposit (initial margin requirement or performance bond) with their futures commission merchant to make sure each party (buyer and seller) can meet the obligations of the futures contract. Initial margin requirements vary depending on commodity and market volatility but are typically a small percentage of the notional value of the contract—often 5% to 6%, or even less. That's a lot lower than the

50% leverage in equities under the Federal Reserve's Regulation T, or "Reg T."

Because futures can be highly leveraged, it's not necessary to tie up a lot of capital to hedge a large portfolio. Futures also make it easier to achieve short market exposure, as compared to stocks or exchange-traded funds (ETFs). Think crude oil prices will decline? A "sell" order initiates a short crude futures contract position. However, shorting a stock or ETF could mean borrowing those shares from your broker. That might involve paying interest charges, making sure you have a large enough account size, and ensuring the shares are available for shorting.

Say a trader holds a \$500,000 portfolio and is concerned about the prospect of negative surprises in an upcoming earnings season. This trader might consider hedging about a third of that portfolio by selling (or shorting) one E-mini S&P 500 contract (/ES) by putting up the initial margin (which was about \$12,000 as of late 2020). Because the notional value of one E-mini S&P 500 contract is \$50 times the index price, with /ES at 3,500, the initial margin would represent about 7% of the notional value:

$$(\$50 \times 3,500) = \$175,000$$

$$\$12,000 / \$175,000 = 0.069, \text{ or } 6.9\%$$

If the S&P 500 drops 50 points, the trader might consider buying back, or "closing out," that futures position. Hypothetically, a \$2,500 gain in the futures position could help offset any unrealized portfolio losses, thereby hedging portfolio risk. By taking a

Contract	Contract Size	Minimum Tick	\$ Value of One Tick	Maintenance Margin*
Crude oil (/CL)	1,000 barrels	\$0.01/barrel	\$10	\$2,000 – \$3,500
Corn (/ZC)	5,000 bushels	\$0.0025 (1/4 cent)	\$12.50	\$650 – \$1,500
Gold (/GC)	100 troy ounces	\$0.10/troy ounce	\$10	\$10,000
E-mini S&P 500 Index (/ES)	\$50 x S&P 500 Index value	\$0.25 index point	\$12.50	\$11,000
10-Year Treasury Note (/ZN)	\$100,000 (face value at maturity)	1/2 of 1/32 of one point	\$15.625	\$1,400

*CME's listed margin requirements as of December 2020.

TABLE 1: STANDARDIZED BUT DIFFERENT. Know the contract specs for any futures contracts you want to trade. For illustrative purposes only.

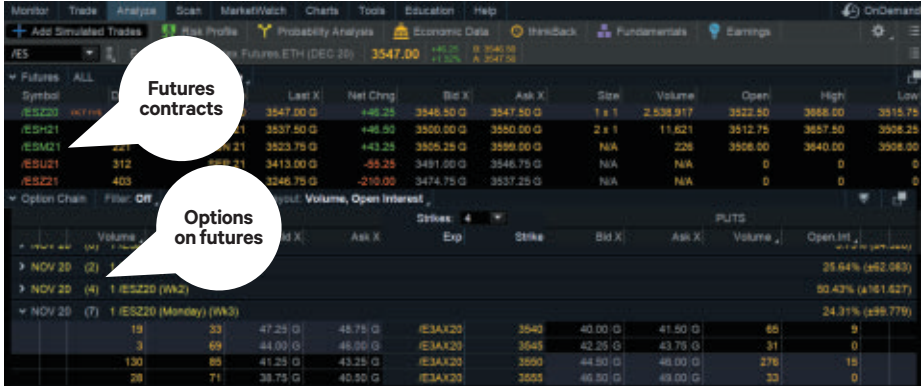


FIGURE 1: FUTURES AND OPTIONS ON FUTURES. On thinkorswim under the Analyze tab, type in the futures symbol to see the futures contracts listed and the Option Chain for each of the contracts below it.

Source: thinkorswim from TD Ameritrade. For illustrative purposes only.

position in the futures contract, traders can gain similar notional exposure while using less capital.

Important reminder: Because margin magnifies profits and losses, a trader could gain or lose more than the initial amount used to purchase the futures position. If prices move against a position, it could result in a margin call. That could mean adding more funds to the account or risk getting liquidated.

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Another big difference: Futures tend to be more volatile than many stocks. Many futures contracts don't trade as actively as large stocks, and futures can experience sharp, sudden price swings. Volatility in futures can be from forces of nature—droughts, hurricanes, geopolitical tensions, etc.

HOW CAN EQUITY OPTION TRADERS BENEFIT FROM FUTURES?

Options and futures are both derivatives: Their values are derived from their underlying asset. But there are differences

between the two. One is the daily cash settlement of futures (in other words, dollars, not gold bullion or barrels of oil). The value of a futures contract either makes or loses money at the end of the trading day. That can weigh on making a decision to either hold or sell the position. Futures traders don't have to worry about time decay (theta) whereas futures options traders do.

Futures also provide nearly round-the-clock access to markets or asset classes while equity options don't. And futures can provide possible diversification benefits.

ANY TRADER READY TO GIVE FUTURES A try can start by creating a watchlist of the most liquid contracts. Knowing what the futures market is doing ahead of the equity market's open could provide a head start to the trading day's actions. Plus, it's a great way to get to know futures.

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For more on the risks of trading and trading futures, see page 35, #1 & 3.

UNIQUE WINDOW THROUGH FUTURES: TAKE A PEEK

For **Stephanie Lewicky, senior manager, trader education, at TD Ameritrade**, futures provide a fascinating “window” into global markets and world events that can inform and enlighten any trading strategy.

Stephanie, why is it important to keep an eye on the futures market and understand how futures work?

Futures trade nearly around the clock, which means contracts like the E-mini S&P 500 can indicate where cash equity markets might open. That can help traders “set up”

for their day. Also, many market-moving events, such as economic reports and quarterly earnings, happen outside regular equity market hours. By following futures, you can gauge potential cash market reaction to, for example, a stronger- or weaker-than-expected earnings report.

How can the futures market provide critical insights for traders, even if they're not trading futures?

Futures are woven into many aspects of our personal and work lives. Do you have a 401(k) that includes a basket of S&P 500 stocks? Call up a 12-month chart of E-mini S&P 500 futures—it may be a good indication of how your 401(k) is doing. How much will you pay to heat your home over the winter or fill your gas tank for a summer road trip? Is now a good time to refinance your mortgage, or should you wait? The futures market can provide insight to those questions too.

How can incorporating futures benefit an equity or equity options trading strategy?

Whether you're trading equities or options on equities, futures can provide a handy tool to hedge an entire portfolio, or just a portion, with a smaller amount of capital. For example, options on major tech stocks could be hedged with E-mini Nasdaq-100 futures (or options on Nasdaq-100 futures). Also, recently launched “micro” versions of futures linked to the Nasdaq-100, S&P 500, and other indices offer a “smaller-bite” alternative to the traditional e-minis. (Micros are one-tenth the size of traditional e-mini contracts.)

EXPLORE

CHECK OUT

You may already be participating in the futures markets. To find out how, read <http://bit.ly/TT-FutHdg>

LEARN

Learn more about trading futures. Log in to your account at tdameritrade.com and, under the **Education** tab, select **Futures > Fundamentals of Futures Trading > Start Course**.



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Vol Crush? It Could Be a Dealbreaker

Have you ever seen implied volatility drop so quickly it killed your trade? Here are a few risk management ideas to consider.

• Say you're convinced a stock will move to the upside. Premiums on the stock's **out-of-the-money** options are relatively high, so what's there to lose? Well, in the options world, things don't necessarily work out as planned. Many factors could catch you off guard, and a big one is a "volatility (vol) crush." If you've been trading options for a while, you're probably smirking, because chances are the vol crush has caught you by surprise at least once.

WHAT IT IS AND WHY IT HAPPENS

A vol crush is a sudden drop in **implied volatility (IV)** that often happens after a significant event such as an earnings report, regulatory decision, or clinical trial outcome. And when it happens, it can bring down the value of an option quite a bit. Why?

An option has both intrinsic and extrinsic value, with the extrinsic value representing risk premium. Let's focus on earnings as an example. As an earnings date approaches, there's a lot of uncertainty about how much

a stock's price could move. This causes the extrinsic value of the option to rise, which often leads to higher IV and increased options premiums.

The stock's expected price move is already priced in to the options. But after earnings are released, there's no more earnings "uncertainty." That component, which was priced in to the option, has fallen to zero, which is why we often see IV drop rapidly after earnings reports.

Remember IV is an approximation of how much a stock's price is likely to change. So, if IV is high prior to earnings, it means the options on the stock will be relatively more expensive. If you buy options prior to earnings and the earnings results don't do much to the stock price, IV may still see a significant drop. This could bring down the price of the options, and you could end up losing money on your positions.

What if the stock price moves a lot after earnings? In that case, the drop in IV may not matter much, especially in options expiring

soon after earnings. There's little extrinsic value, and depending on which way it goes, you could make or lose money.

Although it's possible to make profitable short-term trades that take advantage of a vol crush, it can be risky.

SOME POTENTIAL WORK-AROUNDS

Options closest to expiration tend to be more sensitive. So, if you're looking for less sensitivity, you might consider options that expire further out because a vol crush may not impact them as much. But vega could be greater, all else equal, so you may see a larger value loss. Another workaround may be to compare IV to historical volatility. If IV is extremely high, you may want to wait until it falls closer to normal. And if you notice that IV is high, do your homework. It's probably high for a reason.

—Words by JAYANTHI GOPALAKRISHNAN

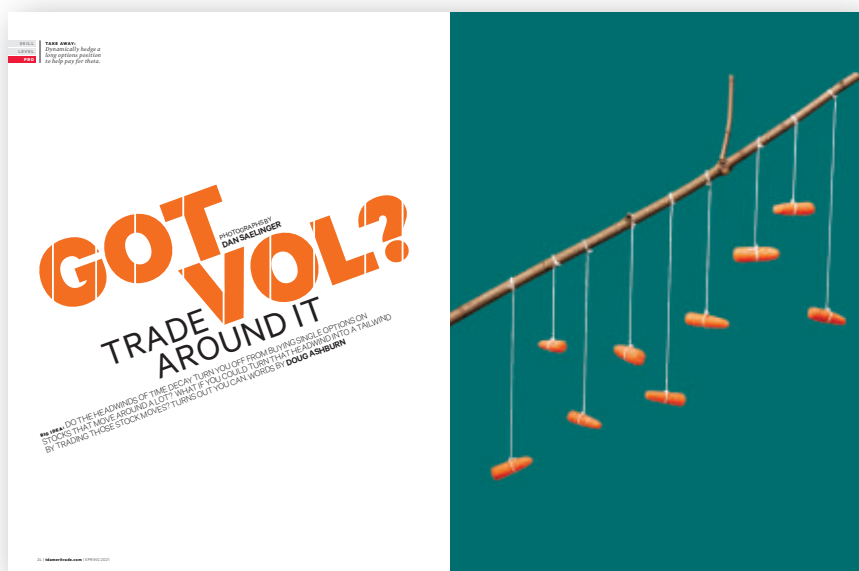
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For more information on the risks of trading and trading options, see page 35, #1 & 2.

CHECK IT OUT

HOW DO YOU SEE THE EXPECTED MOVE?

On the thinkorswim® platform from TD Ameritrade, you can view the Market Maker Move (MMM) next to the price quote. It appears when front-month IV is higher than that of deferred months. The MMM represents a one standard deviation expected move. In other words, 68.2% of the time the close can be within the MMM price range. And remember this is just an approximation. The stock could end up moving much less or more than the expected move.



At the money (ATM)—An option whose strike is “at” the price of the underlying equity. Like out-of-the-money options, the premium of an at-the-money option is all “time” value.

Delta

A measure of the sensitivity of an option to a \$1 change in the underlying asset. All else being equal, an option with a 0.50 delta (for example) would gain \$0.50 per \$1 move up in the underlying. Long calls and short puts have positive (+) deltas, meaning they gain as the underlying gains in value. Long puts and short calls have negative (–) deltas, meaning they gain as the underlying drops in value.

Gamma

A measure of what an option contract’s delta is expected to change per \$1 move in the underlying.

Implied volatility

The market’s perception of the future volatility of the underlying security and is directly reflected in the premium of an option. Implied volatility is an annualized number expressed as a percentage (such as 25%), is forward-looking, and can change.

In the money (ITM)

An option whose premium contains “real” value, i.e., not just time value. For calls, it’s any strike lower than the price of the underlying equity. For puts, it’s any strike that’s higher.

Out of the money (OTM)

An option whose premium is not only all “time” value, but its strike is away from the underlying equity. For calls, it’s any strike higher than the underlying. For puts, it’s any strike that’s lower.

Straddles (long)

A market-neutral, defined-risk position composed of an equal number of long calls and puts of the same strike price. The strategy assumes the market will break out one way or another, in which case a profit occurs when one side of the trade gains more than the other side loses. Break-even points are calculated by adding and subtracting the total debit to and from the strike price of the options.

Strangles (short straddle)

A market-neutral strategy with unlimited risk composed of an equal number of short calls and puts of the same strike price (straddle) or two different strike prices (strangle), resulting in a credit taken in at the onset of the trade. The strategy assumes the underlying will stay within a certain range, in which case, as time passes and/or volatility drops, the options can be bought back cheaper than the credit taken in or expire worthless, resulting in a profit. Break-even points of either strategy at expiration are calculated by adding the total credit received to the call strike and subtracting the total credit received from the put strike.

Theta

A measure of the sensitivity of options to time passing one calendar day. For example, if a long put has a theta of -0.02, the options premium will decrease by \$2 per contract.

Vega

A measure of the sensitivity of options to a one percentage point change in implied volatility. For example, if a long option has a vega of 0.04, a one percentage point increase in implied volatility will increase the options premium by \$4 per contract.

Vertical spread

A defined-risk, directional spread strategy composed of a long and a short option of the same type (that is, calls or puts). Long verticals are purchased for a debit, while short verticals are sold for a credit at the onset of the trade. Long call and short put verticals are bullish, whereas long put and short call verticals are bearish. The risk of a long vertical is typically limited to the debit of the trade, while the risk in the short vertical is typically limited to the difference between the short and long strikes minus the credit.



Why Are You Getting In a Trade?

Are you jumping in and out of stocks, trying to hitch a ride on the next big mover? Here are three really bad ideas.

• Many traders leap before they look, eager to get in on the hype. At times when stocks may post double- or triple-digit gains, it's tempting to jump in to a stock even if it goes against your trading plan. Sure, those trades can sometimes hit gold. But often, they strike rocks.

So, if you're tempted to toss your playbook and throw a long

bomb on the latest initial public offering (IPO), or something you read about on social media, you risk a pick-six. Successful traders have rules and stick to them, whether those rules are based on volatility, probability, technical analysis, or other factors.

Of course, there may be times you break the rules. And once you break your guidelines the first

time, it gets easier to do it again. Eventually, your portfolio no longer matches your goals, and you become an undisciplined trader chasing butterflies.

There's nothing wrong with putting a little money into some of these hype stocks. But for bread-and-butter trades, you should know why you're buying the stock and how it fits into your overall portfolio.

Consider the following three scenarios, which should set off alarm bells that you're leaving your playbook on the bench.

Buying a stock you read about on social media. Stock market chatter on social media isn't necessarily great for assessing a company's value or its shares. Although it's hard to ignore a stock everyone's talking about, when you get caught up in that chatter, take a breather and do a quick review of your trading plan. Does this stock-picking strategy fit your goals? If so, go back to figuring out your entry point. If not, steer clear.

Getting allured by an IPO. There's nothing like the sizzle of an IPO, with a bell ringing and TV interviews on the big day. But don't jump in too quickly. IPOs tend to be volatile, and the market often has trouble pricing them properly. For example, how would you price a travel company that's hinting at an IPO, despite bleeding hundreds of millions of dollars a quarter because of a pandemic?

Then there are all those insiders who've been waiting years to get their hands on the stock so

they can sell it. In this scenario, you're fighting upstream. You may be better off waiting for the dust to settle. Then make sure the stock satisfies everything in your trading plan before adding it to your portfolio.

Making an after-hours "sympathy" trade. Don't get too cute with so-called "sympathy" trades. Let's say you follow a popular tech company that reports big earnings after a close. Then you see shares of its suppliers getting bids and decide to hop on board. Maybe it's a company you've never heard of, but hey, they're tied to your favorite tech company's ecosystem, so what's there to lose?

YOUR MONEY, FOR ONE THING. Remember the trading plan you worked so hard to create? Dig it out and ask yourself if the stock is a fit. Does it bring you closer to your goals, or are you chasing higher shares because everyone else is? Know these answers long before you trade or you risk entering P.T. Barnum territory. As he's rumored to have said, "There's a sucker born every minute." Don't be one. —Words by DAN ROSENBERG

Dan Rosenberg is not a representative of TD Ameritrade, Inc. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc.

For more information on the risks of trading and trading options, see page 35, #1 & 2.

1

GENERAL DISCLAIMER

The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Clients must consider all relevant risk factors, including their own personal financial situations, before trading. Past performance of a security or strategy does not guarantee future results or success.

Transaction costs (commissions and other fees) are important factors and should be considered when evaluating any options trade. Options are not suitable for all investors as the special risks inherent to options trading may expose investors to potentially rapid and substantial losses. Options trading is subject to TD Ameritrade review and approval. Please read Characteristics and Risks of Standardized Options (<http://www.optionsclearing.com/about/publications/character-risks.jsp>) before investing in options.

It is not possible to invest directly in an index.

2

OPTIONS STRATEGIES

Trading options involves unique risks and is not suitable for all investors.

Spreads, condors, butterflies, straddles, and other complex, multiple-leg options strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return. These are advanced options strategies and often involve greater risk, and more complex risk, than basic options trades. Be aware that assignment on short options strategies discussed in this article could lead to unwanted long or short positions on the underlying security.

The maximum potential reward for a long put is limited by the amount that the underlying stock can fall. Should the long put position expire worthless, the entire cost of the put position would be lost.

When trading short options strategies, there is a risk of getting assigned early on the options sold, even if they go in the money by \$0.01, obligating you to deliver shares you don't own (in the case of a short call) or purchase shares (in the case of a short put).

The risk of loss on an uncovered short call options position is potentially unlimited because there is no limit to the price increase of the underlying security. Option writing as an investment strategy is absolutely inappropriate for anyone who does not fully understand the nature and extent of the risks involved.

Short naked put and cash-secured put strategies include a high risk of purchasing the corresponding stock at the strike price when the market price of the stock will likely be lower.

Short naked options strategies involve the highest amount of risk and are only appropriate for traders with the highest risk tolerance.

A covered call strategy can limit the upside potential of the underlying stock position, as the stock would likely be called away in the event of a substantial stock price increase. Additionally, any downside protection provided to the related stock position is limited to the premium received. (Short options can be assigned at any time up to expiration regardless of the in-the-money amount.)

3

FUTURES

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4

SPREAD DISCLOSURES

Options collar: The collar position involves the risks of both covered calls and protective puts.

Options covered call: The covered call strategy can limit the upside potential of the underlying stock position, as the stock would likely be called away in the event of a substantial stock price increase. Additionally, any downside protection provided to the related stock position is limited to the premium received. (Short options can be assigned at any time up to expiration regardless of the in-the-money amount.)

Options long put: The maximum potential reward for a long put is limited by the amount that the underlying stock can fall. This strategy provides only temporary protection from a decline in the price of the corresponding stock. Should the long put position expire worthless, the entire cost of the put position would be lost.

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